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In the Supreme Court of the United States

OCTOBER TERM, 1949

No. 803

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

BASALT ROCK CO., INC.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

The Solicitor General, on behalf of the Commissioner of Internal Revenue, prays that a writ of certiorari issue to review the judgment of the Court of Appeals for the Ninth Circuit.

OPINIONS BELOW

The opinion of the Tax Court (R. 148-170), together with the dissenting opinions (R. 170-179), are reported at 10 T. C. 600. The opinion of the Court of Appeals (R. 220-224) is reported at 180 F. 2d 281.

JURISDICTION

The judgment of the Court of Appeals was entered on February 6, 1950 (R. 224). The jurisdiction of this Court is invoked under 28 U.S.C., Section 1254 (1).

QUESTION PRESENTED

Taxpayers which, for income tax purposes, account for income from long-term contracts on the completed-contract method of accounting were given an election by Section 736 (b) of the Internal Revenue Code to account for such income on the percentage-of-completion method for excess profits tax purposes. Applicable Treasury Regulations provide that, when the election has been exercised, the percentage-of-completion method should be used for purposes of the excess profits tax, whether that tax is computed under Section 710 (a)(1)(A) or under Section 710 (a)(1)(B) of the Internal Revenue Code.

The question is whether the court below erred in holding that a taxpayer which exercises the election is required to compute such income on this basis for purposes of the excess profits tax imposed by Section 710 (a)(1)(A), but is not required to use this accounting method with respect to the computation under Section 710 (a) (1) (B), and in expressly holding invalid the applicable Treasury Regulations which require a contrary result.

STATUTE AND REGULATIONS INVOLVED

The applicable provisions of the statute and regulations are set forth in the Appendix, *infra*, pp. 17-30.

STATEMENT

The Tax Court adopted the stipulated facts as its findings of fact (R. 149). Those which are material

to the issue presented here may be summarized as follows:

The taxpayer is a corporation existing under the laws of California. It is engaged in the business of shipbuilding, and manufacturing concrete aggregates, road and fuel oils, and building materials (R. 149). In the course of its business, the taxpayer has entered into certain contracts whose performance requires more than 12 months. In accordance with the provisions of applicable Treasury Regulations, the taxpayer accounted for the income from these contracts by the completed-contract method of accounting in its income and declared value excess profits tax returns. Its other income was accounted for in accordance with the accrual method of accounting. These methods are also the methods regularly employed by the taxpayer in keeping its books of account. (R. 149-150.)

On or prior to filing its excess profits tax return for 1942, the taxpayer exercised the election provided for in Section 736 (b) (*infra,* pp. 23-24) to compute its income from long-term contracts on the percentage-of-completion method. The issue in this case is whether, because of this election, the percentage-of-completion method of accounting is required in the computation of the taxpayer's surtax net income for the purposes of the excess profits tax imposed by Section 710 (a) (1) (B), it being conceded that this method of computation is required for

determining the taxpayer's adjusted excess profits net income for the purposes of the alternative excess profits tax imposed by Section 710 (a) (1) (A).[1] The parties have stipulated what are the pertinent figures involved under both methods of accounting. (R. 55-63, 76-79, 150-153.)

The Tax Court, in a decision reviewed by the full court, decided that the interpretation made by the Commissioner and set forth in his Regulations (*infra*, pp. 27-30), namely, that the election in Section 736 (b) applies to the computation of corporation surtax net income for the purposes of the tax imposed by Section 710 (a) (1) (B), is correct (R. 148-170). Judge Van Fossan wrote a dissenting opinion, in which Judges Arundell, Black, and Johnson concurred (R. 170-176). A separate dissenting opinion was written by Judge Kern; Judges Black and Arundell agreed with this dissent also (R. 176-179).

The Court of Appeals for the Ninth Circuit reversed the Tax Court. It held that the election

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[1] Section 710(a) (1) imposes a tax upon the adjusted excess-profits net income equal to the lesser of two alternative taxes specified in Section 710(a) (1) (A) and Section 710(a) (1) (B).

Under Section 710(a) (1) (A), the tax is equal to "90 per centum of the adjusted excess-profits net income."

Under Section 710(a) (1) (B), the tax is stated to be

> "an amount which when added to the tax imposed for the taxable year under Chapter 1 (other than section 102) equals 80 per centum of the corporation surtax net income, computed under section 15 or Supplement G, as the case may be, but without regard to the credit provided in section 26(e) (relating to income subject to the tax imposed by this subchapter)."

under Section 736 (b) applied only to the computation required by Section 710 (a) (1) (A), and that the Commissioner's Regulations were invalid in requiring that income from long-term contracts be accounted for on the percentage-of-completion method with respect to the computation of corporation surtax net income for the purposes of the tax imposed by Section 710 (a) (1) (B).

REASONS FOR GRANTING THE WRIT

The court below, reversing the decision of the Tax Court, has invalidated the provisions of a Treasury Regulation which otherwise would have been dispositive of the precise issue of this case. This decision presents a question of substantial importance to the revenue under the provisions of the excess profits tax law. It also raises a fundamental and equally important question concerning the deference to be accorded to the administrative interpretations of the revenue laws, as announced in Treasury Regulations which are promulgated pursuant to statutory authority. The holding below, in declaring invalid the particular provisions of the Regulation here involved, is, when measured against the statute being interpreted, in conflict with the decisions of this Court which have repeatedly declared that the courts must apply the Commissioner's Regulations except when plainly inconsistent with the statute.

1. Taxpayers who regularly keep their books and

report their income from long-term contracts on the completed-contract method of accounting were, in certain circumstances, given an option by Section 736 (b) of the Internal Revenue Code (Appendix, *infra,* pp. 23-24) to compute "income" from such contracts on the percentage-of-completion method of accounting "for the purposes of this subchapter," *i.e.,* for purposes of the excess profits tax, "in accordance with regulations prescribed by the Commissioner with the approval of the Secretary." Those who, like the taxpayer, exercised the election were, however, still required to compute such income on the completed-contract method of accounting for the purposes of the ordinary corporate income taxes imposed by Chapter 1.[2]

The excess profits tax levied by Congress during the taxable year (1942) was 90 percent of a taxpayer's "adjusted excess profits net income" or an amount which, when added to the income tax, equalled 80 per cent of "the corporation surtax net income, computed under section 15" (and computed without regard to the credit provided in Section 26 (e)), the tax being the lesser of these amounts. Section 710 (a) (1) (A) and (B), Internal Revenue Code (Appendix, *infra,* p. 20; fn., *supra,* p. 4). Section 35.736(b)-3, Treasury Regulations 112 (Appendix, *infra,* pp. 27-30), promulgated under the general authority reposing in the Commissioner

[2] These accounting methods are described in Sec. 29.42-4, Treasury Regulations 111 (Appendix, *infra,* pp. 26-27).

as well as under the specific authority granted by Section 736 (b) itself, provides that a taxpayer who exercises the election under that section should, with reference to long-term contracts, account for gross income and deductions by using the percentage-of-completion method of accounting in computing adjusted excess profits net income for the tax imposed under Section 710 (a)(1)(A). It also specifically provides that with respect to the computation under Section 710 (a)(1)(B), the corporation surtax net income computed under Section 15 should likewise be calculated by accounting for income from long-term contracts pursuant to the percentage-of-completion method of accounting which the taxpayer has elected to employ.

The court below held that the taxpayer's election under Section 736 (b) "applied to the computation required by § 710 (a) (1) (A). It did not apply to any of the computations required by § 710 (a) (1) (B)" (R. 223) which refer to "the corporation surtax net income, computed under section 15 * * *." Accordingly, the court ruled that the Commissioner's Regulations were invalid in requiring the taxpayer to use the percentage-of-completion method when accounting for income from long-term contracts in computing the amount of its corporation surtax net income for the purposes of Section 710 (a) (1) (B).

2. The Court of Appeals, unaided by any language in Section 736 (b) or the other excess profits tax provisions, struck down the Commissioner's Regulation because it concluded that the election under Section 736 (b) could be applied only to computations under Section 710 (a)(1)(A), and not to those under Section 710 (a) (1) (B). But, at the very least, it is clear that the Regulation has reasonable warrant in the statute and cannot be said to depart from its wording or plan. The election conferred by Section 736 (b) is not, by its terms, limited to computations under Section 710 (a) (1) (A), nor is it limited to the calculation of "adjusted excess profits net income," on which the tax is imposed under Section 710 (a). On the contrary, the election relates to the computation of "income" for the purposes of the "subchapter" which imposes the excess profits tax, and on its face would seem to require that whenever "income" is to be computed for excess profits tax purposes the percentage-of-completion method must be used.

And it is "income" which, under the statute, is the starting point for computing both "corporation surtax net income" [to which Section 710(a)(1)(B) refers, and the meaning of which forms the nub of the controversy here] and "adjusted excess profits net income" [referred to in Section 710 (a)(1) (A), and which must admittedly be calculated under the Section 736(b) method]. Both of these terms are defined in such a way that they have a

similar, intermediate point of reference, and they both derive from the very same point of origin; accordingly, they should receive a parallel construction. Thus, "adjusted excess profits net income" equals "excess profits net income," with certain credits and adjustments.[3] "Excess profits net income," in turn, is defined as "the normal-tax net income, as defined in section 13(a)(2), for such year," with certain adjustments.[4] This latter concept is, of course, wholly comparable to "corporation surtax net income, computed under section 15," the term which is critical in the present case; and, except for slight differences required by the separate sections of chapter 1 which define them, both terms originate in "net income" under Section 21(a), which is gross income under Section 22, less deductions under Section 23. The amount of a particular taxpayer's net income, of course, depends on what method of accounting is employed with respect to items entering into income. The point is that when a taxpayer elects to use the percentage-of-completion method under Section 736(b) for purposes of the excess profits tax, it has, for the purposes of that tax, elected to use that method in accounting for the positive items of income which enter into "net income," whether that net income subsequently becomes "normal tax net income" and ultimately "adjusted excess profits net income"

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[3] Section 710(b), *infra*, p. 20.

[4] Section 711(a), *infra*, p. 21.

—used in computing the tax under Section 710(a)(1)(A)—or whether that "net income" becomes "corporation surtax net income"—used in computing the tax under Section 710(a)(1)(B). Far from requiring the election to be limited to the former calculation, the statute definitely points the other way. There is no reason to insist that "corporation surtax net income" for Section 710(a)(1)(B) purposes must be computed under the completed-contract method, any more than that the computation of "normal tax net income" for chapter 1 purposes on the completed-contract method must govern the computation of "adjusted excess profits net income" under the first alternative excess-profits tax (Section 710(a)(1)(A)). The court below was therefore wrong in concluding that the amount of the taxpayer's corporation surtax net income for purposes of chapter 1 was its "actual" corporation surtax net income (R. 222). There can be no "actual" amount save by reference to the accounting method which is to be used—the percentage-of-completion method where the excess profits tax is involved, the completed-contract method for the ordinary income tax. At the least, the Commissioner cannot be deemed unreasonable for having taken this position.

In addition to the precise words of the statute, with which the Regulations are thus seen to be in harmony, the Commissioner reasonably understood that Congress did not intend that the alternative measures of the excess profits tax should depend

upon the vagaries that would ensue from using two, inconsistent, accounting methods for alternative computations of the same ultimate tax. It is clear that a taxpayer who has made the election will continue to use the completed-contract method in determining income for purposes of taxation under Chapter 1, while using the percentage-of-completion method for the excess profits tax computed under Section 710 (a) (1) (A). There is nothing, however, in the statute or its legislative history sanctioning the conclusion of the lower court that there is a dual concept of the same income which is subject to the alternative computations of the excess profits tax itself. The Commissioner's Regulations, in requiring that the same accounting method be used in computing the income that is subject to tax under both Section 710 (a) (1) (A) and Section 710 (a) (1) (B), thus avoid the possibility that definite items of income might never be subjected to the excess profits tax, or might be subjected to tax twice, as might be true under the decision below where, with reference, perhaps, to income from the very same long-term contract, a taxpayer could use the percentage-of-completion method of accounting in computing its tax under Section 710(a) (1) (A) in one year and the completed-contract method of accounting in computing its tax in a different taxable year under Section 710 (a) (1) (B). There is no indication that Congress ever intended that some income should completely escape the tax, or should

be taxed twice, by the device of using inconsistent accounting methods in successive years. Cf. *Commissioner* v. *South Texas Co.*, 333 U. S. 496, 503.

3. The foregoing discussion makes plain, we think, that the decision of the Court of Appeals is in conflict with the uniform rulings of this Court that Treasury Regulations must be sustained by the courts unless unreasonable and plainly inconsistent with the statute which they interpret, and that the Regulations constitute contemporaneous constructions of the statute by its administrators which should not be overruled except for weighty reasons. *Commissioner* v. *South Texas Co.*, 333 U. S. 496; *Commissioner* v. *Wheeler*, 324 U. S. 542; *Helvering* v. *Wilshire Oil Co.*, 308 U. S. 90; *Fawcus Machine Co.* v. *United States*, 282 U. S. 375; *Brewster* v. *Gage*, 280 U. S. 327; *Boske* v. *Comingore*, 177 U. S. 459. Moreover, there are special reasons for the application of that principle in this case. The Commissioner's Regulations deal with one of the most complex provisions of any revenue law, the excess profits tax; and Congress made doubly sure that this very aspect of the excess profits tax law would be covered by clarifying interpretations when it specifically provided that the election should be exercised in accordance with Regulations to be promulgated by the Commissioner. *Infra*, pp. 23-24. This Court has noted these two factors as added grounds why Regulations ought to be sustained unless it is perfectly plain that they are in

conflict with the statute. *Commissioner* v. *South Texas Co.*, 333 U. S. 496, 503; *Helvering* v. *Wilshire Oil Co.*, 308 U. S. 90, 102-103.

Even if the legislative language were more ambiguous, the court below should have refrained from nullifying the Regulations, much as it may have preferred a different interpretation itself, so long as the statute and its legislative history did not compel a different construction. Most certainly, it should not have declared that the Regulations were void as repugnant to the statute, when the repugnancy arose only after the court had rewritten the statute in its own fashion.

The burden of an abundance of tax litigation, vexatious to all, can only become more onerous when courts fail to accord due weight to the interpretations officially adopted by those who are charged with the administration of the statute. This is particularly true where, as here, the Regulations are capable of cutting both ways and, while favorable to the revenue in some circumstances, are favorable to taxpayers in other situations. Where a court, instead of inquiring whether the Regulations represent a permissible interpretation of the statute, insists on first drawing its own, independent conclusion concerning the meaning of the legislative language, and upholds the Regulations only if they express an interpretation of the statute which coincides with that which the court has already found to be preferable, an unwholesome situation is

likely to ensue. In such a climate of judicial approach, the Commissioner while applying the Regulations in some instances, would be impelled to deny their validity in every other situation where it would be advantageous to the fisc, thus forcing those taxpayers to resort to litigation to determine what interpretation will find favor with each particular appellate court. And, if a court is free to ignore the Regulations until after it has first selected a particular construction of the statute, opportunity for development of divergent views among the circuits and for the necessity of the intervention of this Court will normally be enhanced.

The present case is not an isolated holding that provisions of the Commissioner's Regulations under the excess profits tax are invalid. In *Commissioner* v. *John Breuner Co.*, No. 805, and in *Commissioner* v. *Busch's Kredit Jewelry Co., Inc.*, No. 804, petitions for writs of certiorari are being filed to review decisions of the Courts of Appeals for the Ninth and Second Circuits in which Regulations promulgated pursuant to Section 736 (a) of the Internal Revenue Code were declared invalid, as had already been the decision in *Kimbrell's Home Furnish., Inc.* v. *Commissioner,* 159 F. 2d 608 (C. A. 4). We believe it to be a matter of prime importance that this Court should again make it plain that its decisions with respect to the deference to be paid to the Commissioner's Regulations announce controlling principles.

4. The decision below raises a question of substantial importance in the administration of the revenue. As was indicated previously, while the interpretation adopted by the Commissioner in his Regulations results in a greater tax on this taxpayer than would be true under the decision of the court below, in the case of other taxpayers a larger tax would be owing if the Commissioner should be compelled to disregard his Regulations and should be required to follow the decision of the Court of Appeals.[5] Acting on the assumption that the Regulations express the proper view of the statute, and that taxpayers ought not to be compelled to resort to litigation to test their validity, the Bureau of Internal Revenue has already accepted returns in all other cases where taxpayers have followed the Regulations, notwithstanding that application of the Regulations has resulted in less tax in some cases, and has even made large refunds of taxes in other cases. Unless the decision in this case is reviewed by this Court, the Commissioner, to protect the revenue, will be required to determine deficiencies or to institute suits to recover refunds against these taxpayers, where such action has not become barred.

The question is also important to the revenue from the viewpoint of the total amount of tax in-

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[5] *I.e.*, the amount of corporation surtax net income (under Section 710(a)(1)(B)) may be greater if computed under the completed-contract method than under the percentage-of-completion method permitted by Section 736(b).

volved. The present case alone involves a difference of approximately $1,300,000 in tax, depending on whether the decision below is correct. In another case (*Sokol Brothers Furniture Co.* v. *Commissioner,* decided March 10, 1949 (1949 P-H T. C. Memorandum Decisions, par. 49,064)), the Tax Court followed its decision here; that case is now pending in the Court of Appeals for the Fifth Circuit. We are advised that there are some 12 other pending cases, involving Section 736 (b), which involve substantial amounts of revenue. We are also informed that there are 14 additional pending cases, involving Section 721 of the Code, with respect to which the application of the decision here will involve substantial amounts of revenue.

CONCLUSION

For the foregoing reasons this petition for a writ of certiorari should be granted.

Respectfully submitted,

PHILIP B. PERLMAN,
Solicitor General.

MAY, 1950.

APPENDIX

Internal Revenue Code:

SEC. 13 [As amended by Section 201 of the Revenue Act of 1939, c. 247, 53 Stat. 862.] TAX ON CORPORATIONS IN GENERAL.

(a) *Definitions.—For the purposes of this chapter—*

(1) *Adjusted Net Income.*—The term "adjusted net income" means the net income minus the credit provided in section 26 (a), relating to interest on certain obligations of the United States and Government corporations.

* * * * *

(2) [As amended by Section 105 (a)(1) of the Revenue Act of 1942, c. 619, 56 Stat. 798] *Normal-Tax Net Income.*—The term "normal-tax net income" means the adjusted net income minus the credit for income subject to the tax imposed by Subchapter E of Chapter 2 provided in section 26 (e) and minus the credit for dividends received provided in section 26 (b).

* * * * *

[26 U. S. C. 1946 ed., Sec. 13]

SEC. 15 [As amended by Section 105 (b) of the Revenue Act of 1942, *supra*]. SURTAX ON CORPORATIONS.

(a) *Corporation Surtax Net Income.*—For the purposes of this chapter, the term "corporation surtax net income" means the net in-

come minus the credit for income subject to the tax imposed by Subchapter E of Chapter 2 provided in section 26 (e) and minus the credit for dividends received provided in section 26 (b) (computed by limiting such credit to 85 per centum of the net income reduced by the credit for income subject to the tax imposed by Subchapter E of Chapter 2 in lieu of 85 per centum of the adjusted net income so reduced), and minus, in the case of a public utility, the credit for dividends paid on its preferred stock provided in section 26 (h). For the purposes of this subsection dividends received on the preferred stock of a public utility shall be disregarded in computing the credit for dividends received provided in section 26 (b).

* * * * *

[26 U. S. C. 1946 ed., Sec. 15]

SEC. 21. NET INCOME.

(a) *Definition.*—"Net income" means the gross income computed under section 22, less the deductions allowed by section 23.

(b) [As amended by Section 210 (a) of the Revenue Act of 1939, *supra*] *Cross References.*—For definition of "adjusted net income" and "normal-tax net income", see section 13.

* * * * *

[26 U. S. C. 1946 ed., Sec. 21]

SEC. 26. CREDITS OF CORPORATIONS.

In the case of a corporation the following

credits shall be allowed to the extent provided in the various sections imposing tax—

* * * * *

(e) [As amended by Section 105 (d) of the Revenue Act of 1942, *supra*] *Income Subject to Excess-Profits Tax.*—In the case of any corporation subject to the tax imposed by Subchapter E of Chapter 2, an amount equal to its adjusted excess-profits net income (as defined in section 710 (b)). In the case of any corporation computing such tax under section 721 (relating to abnormalities in income in the taxable period), section 726 (relating to corporations completing contracts under the Merchant Marine Act of 1936), section 731 (relating to corporations engaged in mining strategic minerals), or section 736 (b) (relating to corporations with income from long-term contracts), the credit shall be the amount of which the tax imposed by such subchapter is 90 per centum. For the purpose of the preceding sentence the term "tax imposed by Subchapter E of Chapter 2" means the tax computed without regard to the limitation provided in section 710 (a)(1)(B) (the 80 per centum limitation), without regard to the credit provided in section 729 (c) and (d) for foreign taxes paid, and without regard to the adjustments provided in section 734. This subsection shall not apply to any corporation exempt from such tax under section 725 or section 727.

* * * * *

[26 U. S. C. 1946 ed., Sec. 26]

SEC. 710 [As added by Section 201 of the Second Revenue Act of 1940, c. 757, 54 Stat. 974.] IMPOSITION OF TAX.

(a) [As amended by Section 201(a) of the Revenue Act of 1941, c. 412, 55 Stat. 687, and Section 202 of the Revenue Act of 1942, *supra*] *Imposition.*—

(1) *General Rule.*—There shall be levied, collected, and paid, for each taxable year, upon the adjusted excess-profits net income, as defined in subsection (b), of every corporation (except a corporation exempt under section 727) a tax equal to whichever of the following amounts is the lesser:

(A) 90 per centum of the adjusted excess-profits net income, or

(B) an amount which when added to the tax imposed for the taxable year under Chapter 1 (other than section 102) equals 80 per centum of the corporation surtax net income, computed under section 15 or Supplement G, as the case may be, but without regard to the credit provided in section 26 (e) (relating to income subject to the tax imposed by this subchapter).

* * * * *

(b) *Definition of Adjusted Excess Profits Net Income.*—As used in this section, the term "adjusted excess profits net income" in the case of any taxable year means the excess profits net income (as defined in section 711) minus the sum of:

* * * * *

[26 U. S. C. 1946 ed., Sec. 710]

SEC. 711 [As added by Section 201, Second Revenue Act of 1940, *supra*]. EXCESS PROFITS NET INCOME.

(a) *Taxable Years Beginning After December 31, 1939.*—The excess profits net income for any taxable year beginning after December 31, 1939, shall be the normal-tax net income, as defined in section 13 (a)(2), for such year except that the following adjustments shall be made:

* * * * *

[26 U. S. C. 1946 ed., Sec. 711]

SEC. 736 [As added by Section 222 (d) of the Revenue Act of 1942, *supra*]. RELIEF FOR INSTALLMENT BASIS TAXPAYERS AND TAXPAYERS WITH INCOME FROM LONG-TERM CONTRACTS.

(a) *Election to Accrue Income.*—In the case of any taxpayer computing income from installment sales under the method provided by section 44 (a), if such taxpayer establishes, in accordance with regulations prescribed by the Commissioner with the approval of the Secretary, that the average volume of credit extended to purchasers on the installment plan in the four taxable years preceding the first taxable year beginning after December 31, 1941, was more than 125 per centum of the volume of such credit extended to such purchasers in the taxable year, or the average outstanding installment accounts receivable at the end of each of the four taxable years preceding the first taxable year beginning after December 31, 1941, was more than 125 per

centum of the amount of such accounts receivable at the end of the taxable year, or if the taxpayer was not in existence for four previous taxable years, the taxable years during which the taxpayer was in existence, in either case including only such years for which the income was computed under the method provided in section 44 (a), it may elect, in its return for the taxable year, for the purposes of the tax imposed by this subchapter, to compute, in accordance with regulations prescribed by the Commissioner with the approval of the Secretary, its income from installment sales on the basis of the taxable period for which such income is accrued, in lieu of the basis provided by section 44 (a). Except as hereinafter provided, such election shall be irrevocable when once made and shall apply also to all subsequent taxable years, and the income from installment sales for each taxable year before the first year with respect to which the election is made but beginning after December 31, 1939, shall be adjusted for the purposes of this subchapter to conform to such election. In making such adjustments, no amount shall be included in computing excess profits net income for any excess profits tax taxable year on account of installment sales made in taxable years beginning before January 1, 1940. If the taxpayer establishes, in accordance with regulations prescribed by the Commissioner with the approval of the Secretary, that in a taxable year subsequent to the year with respect to which an election has been made under the preceding provisions of this subsection it

would not be eligible to elect such accrual method, the taxpayer may in accordance with such regulations elect in its return for such year to abandon such accrual method. Such election shall be irrevocable when once made and shall preclude any further elections under this subsection. For the taxable year for which the latter election is made and subsequent taxable years, income shall be computed in accordance with section 44 (c).

(b) *Election on Long-Term Contracts.*—In the case of any taxpayer computing income from contracts the performance of which requires more than 12 months, if it is abnormal for the taxpayer to derive income of such class, or, if the taxpayer normally derives income of such class but the amount of such income of such class includible in the gross income of the taxable year is in excess of 125 per centum of the average amount of the gross income of the same class for the four previous taxable years, or, if the taxpayer was not in existence for four previous taxable years, the taxable years during which the taxpayer was in existence, it may elect, in its return for such taxable year for the purposes of this subchapter, or in the case of a taxable year the return for which was filed prior to the date of the enactment of the Revenue Act of 1942, within 6 months after the date of the enactment of such Act, to compute, in accordance with regulations prescribed by the Commissioner with the approval of the Secretary, such income upon the percentage of completion method of account-

ing. Such election shall be made in accordance with such regulations and shall be irrevocable when once made and shall apply to all other contracts, past, present, or future, the performance of which required or requires more than 12 months. The net income of the taxpayer for each year prior to that with respect to which the election is made shall be adjusted for the purposes of this subchapter, including the computation of excess profits net income in each taxable year of the base period under section 711 (b), to conform to such election but for purposes of chapter 1, the tax imposed by this subchapter for any prior taxable year on account of the adjustment required by this subsection shall be considered a part of the tax imposed by this subchapter for the taxable year in which such income is, without regard to this subsection, includible in gross income. Income described in this subsection shall not be considered abnormal income under section 721.

* * * * *

[26 U. S. C. 1946 ed., Sec. 736]

Treasury Regulations 111, promulgated under the Internal Revenue Code:

SEC. 29.13-1. *Tax on Corporations in General.*—* * * The tax imposed by section 13 is computed upon the "normal-tax net income," that is, the adjusted net income minus the credit provided in section 26 (e) for income subject to the excess profits tax imposed by

subchapter E of chapter 2 and minus the credit for dividends received provided in section 26 (b), relating to dividends received from a domestic corporation which is subject to taxation under chapter 1 (85 percent of dividends received, but not in excess of 85 percent of the adjusted net income reduced by the credit provided in section 26 (e) for income subject to the excess profits tax imposed by subchapter E of chapter 2). The "adjusted net income" of a corporation is the net income as defined in section 21 minus the credit provided in section 26 (a), relating to interest on certain obligations of the United States and its instrumentalities.

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SEC. 29.15-1. *Surtax on Corporations.*— * * *

The "corporation surtax net income" of a corporation is its net income minus (1) the credit provided in section 26 (e) for income subject to the excess-profits tax imposed by subchapter E of chapter 2, (2) the credit provided in section 26 (b) for dividends received, and (3) in the case of a public utility, the credit provided in section 26 (h) for dividends paid on its preferred stock. For the purposes of determining the corporation surtax net income, dividends received on the preferred stock of a public utility must be disregarded in computing the credit provided in section 26 (b) for dividends received. Also, for such purposes, such credit is limited to 85 percent of the corporation's net income (reduced by the credit

provided in section 26 (e) for income subject to the excess profits tax imposed by subchapter E of chapter 2), rather than to 85 percent of the adjusted net income so reduced. The credit provided in section 26 (a) for interest received on obligations of the United States or its instrumentalities is not allowable in computing corporation surtax net income.

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SEC. 29.42-4. *Long-Term Contracts.*—Income from long-term contracts is taxable for the period in which the income is determined, such determination depending upon the nature and terms of the particular contract. As used in this section the term "long-term contracts" means building, installation, or construction contracts covering a period in excess of one year from the date of execution of the contract to the date on which the contract is finally completed and accepted. Persons whose income is derived in whole or in part from such contracts may, as to such income, prepare their returns upon either of the following bases:

(a) Gross income derived from such contracts may be reported upon the basis of percentage of completion. In such case there should accompany the return certificates of architects or engineers showing the percentage of completion during the taxable year of the entire work to be performed under the contract. There should be deducted from such gross income all expenditures made during the taxable year on account of the contract,

account being taken of the material and supplies on hand at the beginning and end of the taxable period for use in connection with the work under the contract but not yet so applied.

(b) Gross income may be reported for the taxable year in which the contract is finally completed and accepted if the taxpayer elects as a consistent practice so to treat such income, provided such method clearly reflects the net income. If this method is adopted there should be deducted from gross income all expenditures during the life of the contract which are properly allocated thereto, taking into consideration any material and supplies charged to the work under the contract but remaining on hand at the time of completion.

A taxpayer may change his method of accounting to accord with paragraph (a) or (b) of this section only after permission is secured from the Commissioner as provided in section 29.41-2.

Treasury Regulations 112, promulgated under the Internal Revenue Code:

SEC. 35.736(b)-2 *Election To Report Income Upon Percentage of Completion Basis.*—If the taxpayer satisfies the eligibility requirements provided in section 736 (b) and section 35.736 (b)-1 with respect to a taxable year beginning after December 31, 1939, it may elect in its excess profits tax return for such year, or if the election is made for a taxable year the excess profits tax return for which was filed prior to October 21, 1942 (the date of enactment of

the Revenue Act of 1942), it may elect not later than April 21, 1943 (six months after the date of enactment of the Revenue Act of 1942), to compute its income from long-term contracts upon the percentage of completion method of accounting under the provisions of section 29.42-4(a) of Regulations 111 or section 19.42-4(a) of Regulations 103 applicable to the taxable year for which the tax is being computed. An election made by the taxpayer pursuant to the provisions of section 30.736(b)(2) of Regulations 109 shall be deemed to be made pursuant to the provisions of this section.

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SEC. 35.736(b)-3 [Amended by T. D. 5388, 1944 Cum. Bull. 387] *Computation of Net Income Upon Percentage of Completion Method of Accounting.*—(a) *Excess profits tax taxable year.*—If a taxpayer has elected under section 736 (b) and section 35.736(b)-2 to compute for excess profits tax purposes its net income from long-term contracts upon the percentage of completion method of accounting, in lieu of the completed contract basis, gross income from such long-term contracts shall be reported for each excess profits tax taxable year upon the basis of percentage of completion of such contract in such year. There shall be deducted from such gross income for a taxable year all expenditures made during such year on account of the contract, account being taken of the material and supplies on hand at the beginning and end of the taxable

year for use in connection with the work under the contract but not yet so applied. Any deductions under section 23 which are limited to a percentage of net income (computed without regard to such deduction, as for example, the deduction for charitable contributions which is allowed by section 23 (q)) shall, for excess profits tax purposes, be determined upon the basis of such net income with the income from long-term contracts computed upon the percentage of completion method of accounting, and not upon the basis of net income for Chapter 1 purposes. No reserve for bad debts arising from accounts receivable from long-term contracts may be set up for excess profits tax purposes unless a reserve has been established for income tax purposes.

In computing the net operating loss deduction for the purposes of the excess profits tax for a taxable year pursuant to section 23 (s), section 122, and section 711 (a)(1)(J) or section 711 (a)(2)(L), the net operating loss under section 122 (a) and the net income under section 122 (b) for any taxable year prior or subsequent to the taxable year in which the election under section 736 (b) and section 35.736(b)-2 is made shall be determined by computing income from long-term contracts upon the percentage of completion method of accounting. The excess profits net income for the taxable year for which the net operating loss deduction is computed shall, for the purposes of the reduction provided by section 711 (a)(1) (J) (ii) or section 711 (a)(2)(L) (ii), be determined by computing income from

long-term contracts upon the percentage of completion method of accounting.

In computing normal tax net income for the purposes of determining excess profits net income, the credit for dividends received shall be limited to 85 percent of the adjusted net income computed by determining income from long-term contracts upon the percentage of completion method of accounting as provided in section 736 (b) and this section, instead of upon the completed contract basis.

The excess profits tax may be computed under section 710(a)(1)(B) as an amount which when added to the normal tax and surtax computed under Chapter 1 for the taxable year equals 80 percent of the corporation surtax net income properly adjusted under the provisions of section 710 (a)(1) (B) applicable to such year. For such purpose, the corporation surtax net income shall be determined by computing the income from long-term contracts upon the percentage of completion method of accounting. The credit for dividends received used in computing corporation surtax net income shall be limited to 85 percent of the net income determined by computing income from long-term contracts upon the percentage of completion method of accounting, and the normal tax and surtax shall be the actual normal tax and surtax determined under Chapter 1.

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